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SUBJECT: JURASSIC PARK ON THE TIGRIS: SAVING BAGHDAD'S
ECONOMY FROM INDUSTRIAL DINOSAURS

This is a Baghdad EPRT-2 reporting cable.

11. Summary: The Baghdad economy depends heavily on state-owned enterprises (SOEs), but these dinosaurs have uncertain prospects in Iraq's nascent free-market economy. Poor leadership and daunting capital needs are their biggest challenges. We need to have realistic expectations for the restructuring and privatization of SOEs in Baghdad. While there is no hope for some, we must remain engaged with others to capitalize on opportunities for both short-term counterinsurgency gains and longer term economic development. End summary.

SOEs Still Dominate the Economy

12. (SBU) Outside of the public service, SOEs are the largest employers in the eastern Baghdad districts of Rusafa, Karada, and 9 Nissan -- EPRT-2's area of operations (AO). Over 77 SOEs employ an estimated 40,000 people making a wide range of products -- paints, foods, plastic items, electrical appliances, bottled drinks, construction materials, cooking oil, agricultural supplies, leather goods and apparel. Almost all medium and heavy industry in the AO is state-owned. Over the past 18 months, EPRT-2 has visited many of these SOEs and implemented projects with several of them, trying to stimulate productivity and increase employment. The results have been mixed. SOEs in Baghdad face two main challenges: people and capital. Because these SOEs employ so many people, their progress will have an important effect on both the local economy in Baghdad and on its security.

Dinosaurs in a Tarpit

13. (SBU) Iraq's changing economy worries SOE managers in Baghdad. Many hope the future will be like the past; they are content to wait for the GOI to ride to the rescue and revive the pre-2003 command economy. The director general (DG) of National Chemical and Plastics Industries (NCPI) recently admitted, "The employees and I are looking at the Saddam days as the glory days. The old regime used to support domestic production." Other DGs are quick to suggest that Coalition Forces should support their SOEs. Failing that, they hope the GOI will "take care of us." Many managers are demoralized and even emotionally overwhelmed by the jolting economic changes of the past few years. They frequently look for scapegoats, with Iranian and Chinese imports at the top of the list. The technical director at NCPI, for example, reasoned that because imports were being sold cheaper than his inputs, there was "a conspiracy to destroy Iraqi industry."

¶4. (SBU) Some SOE managers in the EPRT-2 AO are open to change and motivated to adapt to the new rules of competitive business and management practices. Frequently, however, they do not have the skills or mindset the free market demands. We visited two SOEs to inquire about their participation in a Ministry of Industry and Minerals (MIM) program to fund turn-around plans for SOEs. We were handed two "business plans" that were essentially bills of quantity and pricing for production equipment with no strategic, financial or sales plans attached. The managers were simply looking to restart production, unaware of the need for training or strategic management.

¶5. (SBU) Managers skilled in sales and marketing are especially rare. NCPI,s DG, for example, responded to a question about the role of his sales force by saying, "We have a sales force, but no one calls them anymore." The DG of Modern Paints Industries (MPI), which is partially state-owned, told us his new "marketing strategy" was to try to get city building codes changed to require the use of his company,s paint.

¶6. (SBU) Even when a manager has the will and the skills to succeed, GOI interference can keep SOE dinosaurs trapped in the tarpit. The DG of the State Company for Vegetable Oils (SCVO), an SOE in Baghdad's Karada neighborhood, told us in August that MIM had ordered SOEs to increase workers' salaries by 80 percent and return idle workers to full-time status. (Note: Most SOEs have many "employees" who get paid but do not regularly come to work. End note.) The directive

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forced SCVO to bring over 2,000 workers back, even though the company,s production lines were stalled because of an overstock of product. These constricting mandates do not allow managers to make crucial decisions to cut overhead and make the companies profitable. Furthermore, the Ministry also limits the ability of managers to perform crucial functions such as issue debt, raise capital, purchase or sell property, and negotiate the terms of joint ventures.

Capital Infrastructure Outdated, Investment Needs Large

¶7. (SBU) Lack of modern equipment is the second huge obstacle standing between SOEs and increased production capacity. Because of Iraq,s wars and the UN embargo, almost all capital infrastructure is at least 20 years old. Even if equipment has not been looted or stolen, it is generally in poor repair and woefully out of date. Much equipment was manufactured in East Germany or the Soviet Union and often the manufacturer no longer exists, making it impossible to find parts to resurrect production lines. Ingenious engineers must improvise replacement parts to keep such equipment operating despite rampant cannibalization.

¶8. (SBU) Working capital is non-existent in many companies in Baghdad. This is especially hard on SOEs that have to manage long, dysfunctional supply chains. SCVO, for example, must import its feedstock of vegetable oils from as far away as Malaysia and Brazil. Transactions to procure the oil require navigation through a labyrinth of personnel at various ministries. After the bureaucrats approve a purchase, an SOE bank must coordinate the transfer. This system exacerbates the shortage of working capital.

¶9. (SBU) Investment needs among SOEs in EPRT-2's AO are large, ranging up to \$100 million. For now, SOEs cannot move forward unless the state or large investors provide capital for equipment and operations. While MIM has begun implementing a limited program to supply capital to SOEs, the effort is limited by the enterprises, management capability and the funds available to each company. The DG of MPI told us in October that MIM had recently set aside \$85 million for the mixed sector. Loans would be interest-free for two years

and cost four percent after that. The DG of NCPI reported in October that loans would be at six percent for five years. MPI and NCPI have been allocated \$4 million and \$7 million for their investment projects. It was not clear to either DG how these decisions were made.

¶10. (SBU) Poor security strictly limits prospects for international investment in Iraq's SOEs. Further obstacles to investment are inadequate banking and investment laws, and the complicated management structure imposed by GOI ownership. DGs report that while MIM has encouraged them to court foreign joint ventures, the Ministry has provided no support or guidance. Meanwhile, the private Iraqi investors in mixed enterprises are waiting for the GOI to show leadership. One DG told us that his private shareholders were interested in investing more in the company, but were holding off to see what resources the GOI would give to the companies and what the GOI planned to do with its shares.

Comment

¶11. (SBU) While there is a strong free-market argument to letting SOE dinosaurs in Baghdad fail, this could undermine our counter-insurgency strategy. Keeping SOE employees on the payroll reduces incentives to join an insurgency or turn to criminal groups for sustenance. To the extent that insurgent activity is economically driven, letting SOEs fail poses the risk of turning up to 40,000 bread-winners into the streets of East Baghdad, and potentially reversing the hard-won security gains of the past year.

¶12. (SBU) Thus, despite the dismal long-term economic outlook for most SOEs, security concerns argue for continued engagement with them to avoid a large economic disruption at this critical time. Neither EPRT-2 nor the U.S. military has the resources or capacity to facilitate wholesale turnarounds for these companies. Thus our primary focus will remain on propping them up over the short term. Helping NCPI, for example, make sub-contracting arrangements with USG contractors keeps workers and equipment active and buys time for the managers and the GOI to develop a transition plan.

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¶13. (SBU) A few companies have the potential to make the transition. With MPI, the EPRT piloted a management-training program earlier in the fall designed to transform the sales and marketing team from an order-taking organization to a streamlined sales force. Initial results have been hopeful though the real effect will only be visible later.

¶14. Finally, working with SOEs provides opportunities to educate on a broader scale and to teach modern management skills to Iraqis who may be in the workforce for decades to come. Although a USAID-funded Small Business Development Center offers courses in basic management skills in the EPRT-2 AO, little is available for the middle or upper manager of a larger enterprise. The effort may not ultimately reverse any particular company, but it can improve the management skills of a large group of mid-level managers.

These skills will be important no matter where they are applied to rebuild Iraq's economy.

CROCKER